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In the

Supreme Court of the United States

October Term, 1951

No. 270

HELEN BLESI PEARSON AND J. CHARLES PEARSON, JR.,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

REPLY BRIEF FOR PETITIONERS

STEPHEN L. MAYO,
J. EDWIN FLEMING,
625 Republic Bank Building,
Dallas, Texas,
Counsel for Petitioners.

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REPLY BRIEF FOR PETITIONERS

The misconstruction of the law and disregard of the facts in the opinion below and Respondent's Brief in Opposition are such as not only to invite but to demand challenge and answer in this, Petitioners' Reply Brief.

SUMMARY OF ARGUMENT

1.

The decision of the court below is incorrect. *First National Bank of Kansas City v. Nee, 190 F. 2d 61 (C. A. 8th)*, relied on by respondent is distinguishable because decedent there did not *own* the building which the heir sought to depreciate. Not only the *land* but also the *building* was inherited by the petitioners.

2.

The decision below is in conflict with the controlling principle of law in *Crane v. Commissioner, 331 U. S. 1, Brown Shoe Co. v. Commissioner, 339 U. S. 583, Blanchard v. Commissioner, 184 F. 2d 438 (C. A. 3rd)* and *Rogers v. Helvering, 107 F. 2d 394 (C. C. A. 2d).*

3.

To allow petitioners depreciation would not be an incongruous result. Even if such resulted, the court should not attempt to remove the incongruity in the face of clear and unambiguous statutory provisions which require such result.

ARGUMENT

1.

Respondent concedes that the "basis" for computing the amount of depreciation deductible annually, where the property is acquired by inheritance, is the "fair market value" at the time the property was acquired. But, says Respondent, the Petitioners need not concern themselves with determining their basis because they do not possess "a depreciable interest" in the property. (Resp. Br. 6.) *First National Bank of Kansas City v. Nee, supra,* is cited for authority. However, Respondent fails to acknowledge the critical distinction that in that case the taxpayer did not own the property in respect to which the depreciation was claimed. That is the reason the taxpayer possessed "no depreciable interest" in the property. It was not because the decedent-lessor had no "cost" or "investment" in the property.

Respondent would seem to have the Court believe that in this case the decedent-lessor possessed only an interest in the land: "She had a fee interest in land subject to an outstand-

ing lease * * *." This is not correct. She had a fee interest in the land and building subject to an outstanding lease. To follow Respondent's reasoning here is to say that if, at the death of the ancestor, the ancestor had no depreciable interest in the property, the heir would receive no depreciable interest. This reasoning does violence to the explicit statutory plan for substituted basis provided for by the Code. For example, suppose the ancestor had exhausted her cost basis in certain property by depreciation deductions so that at the time of her death she was not entitled to further such deduction. The reasoning of the Respondent would require that the heir would not be entitled to deductions for depreciation even though the inherited depreciable property had a high fair market value. Certainly this cannot be the rule.

The whole purpose of the Code provision providing for a "substituted basis" in cases of inherited property, is to give the new owner a new basis without regard to the adjusted or unadjusted basis of the ancestor from whom the property was acquired. While we do not think it to be of controlling importance here, the trial court found that Mrs. Rowan, the ancestor, had an adjusted basis of $35,000.00 in the buildings which were on the property at the time the lease was executed and which were demolished to make way for the new structure. She claimed and was allowed an annual amortization deduction in her subsequent tax returns in the amount of $583.33. This amount was based upon the remaining 60 year period of the lease. (R. 24-25, 123.) At the time of her death (1940), she still had a basis in the property subject to those annual deductions. Re-

spondent wants to forget about that. He seems to pitch his whole argument on the proposition that: "Since the decedent-lessor had no depreciable interest in the building during her lifetime, she could transmit none to taxpayer upon her death." (Resp. Br. 7.) This is merely argument urged by Respondent in the court below which was not accepted by that court. In the case of inherited property, basis is not "transmitted" at death. The whole purpose of Code Sec. 113 (a) (5) is to give the new owner a new basis without regard to the decedent's basis. The new basis, measured by fair market value, may be greater or less than, or by coincidence equal to, the decedent's basis. The point is that such basis is a new and different thing. *Buelterman v. U. S., 155 F. 2d 597, 601 (C. C. A. 8th, 1946.)* This provision of the Code is without any ifs, ands and so-forths.

The court below did not hold that the Petitioners did not "possess a depreciable interest." It recognized that Petitioners owned the building and were entitled to depreciation based on the fair market value thereof, *provided* Petitioners had proved what portion, if any, of the value used for federal estate tax purposes was attributable to the depreciable property (building) as distinguished from the non-depreciable property (land). The court rather lamely concluded that Petitioners had failed somehow to discharge such a burden of proof. The Respondent emphasizes the lower court's reference to the estate tax valuation as appearing to be attributable to the land alone (Resp. Br. 8) and on this basis urges the correctness of the decision. This is nothing more than contending that the value used for estate tax purposes is conclusive in attempting to establish

the heir's basis for depreciation purposes. It is noteworthy that Respondent cites no authority for this argument and, indeed, there is none other than the opinion of the court below.

The stipulation as to the fair market value of the building was intended to establish the minimum fair market value of the building "at the time of acquisition," the critical date for basis of inherited property under Code Sec. 113 (a) (5). Accordingly, if the statute is to be followed, the stipulation serves to establish the Petitioners' basis in the building. The court below professes not to comprehend the "intended" purpose of the stipulation. (R. 189.) Certainly it could have no bearing on the *lessee's* basis for amortization purposes. The stipulation does not undertake to demonstrate that the "building was accorded any value" for estate tax purposes, nor would that seem essential. Nevertheless, the lower court held that since the building was not assigned a separate value for estate tax purposes, its basis, in the hands of the heirs could not be established. The Respondent asserts that the petition for certiorari "proffers no answer to the reasoning of the court below. It proceeds solely upon the hypothesis, without basis in the record, that the stipulation of the parties as to fair market value of the building *ipso facto* established that the taxpayer possessed a depreciable interest in the building." (Resp. Br. 8.) What Petitioners have attempted to make clear is that the reasoning of the lower court is fallacious because it holds the estate tax valuation of the building to be conclusive for income tax purposes. Petitioners' basis for depreciation is in the law and the proof of the minimum basis for depreciation is indisputably in the record.

Respondent constantly says taxpayers did not "possess" a depreciable interest in the building. Must one "possess" more than *ownership* in order to be entitled to depreciation when basis measurement is supplied by statute? Actually, Respondent is urging that since decedent "possessed" no depreciable interest in the new building (doubtless because as to the decedent there was no incident of cost or other basis) the heir can "possess" no depreciable interest. Again this is proposing the erroneous rule (or donor-donee rule) that the decedent's basis is *transferred* to the heir.

Respondent's theory of no depreciation unless the taxpayer possesses an "economic interest" and suffers an "economic loss" is mere repetition of a proposition which the court below refused to accept. If this theory were correct a donee would never possess a depreciable interest in property, having paid nothing for it, and the same would be true in every case of inherited property since such property passes without "investment"or "cost" to the heir. Congress could well have provided that, in the case of a transfer of property at death, the heir's basis shall be the same as the decedent's basis. It is significant to note that Congress did provide that, in the case of a transfer of property by gift, as a general rule, the donee's basis shall be the same as that of the donor. Sec. 113 (a) (2) Internal Revenue Code. The fact that similar treatment was not applied to the basis of inherited property indicates that Congress knew what it was doing and what it intended.

All that can be said for Respondent's argument in support of the lower court's decision is that he agrees with the *result* but disagrees with the principles employed by

the court in reaching its conclusion that Petitioners are not entitled to depreciation deductions on an obviously wasting asset.

2.

Respondent argues that *Crane v. Commissioner*, *supra*, and *Brown Shoe Co. v. Commissioner*, *supra*, do not present an issue comparable to that here involved. (Resp. Br. 9.) Petitioners do not at all contend that the fact situations in those cases are comparable to the facts here. However, it is contended that the controlling legal principle in those cases is in direct conflict with that announced by the court below. In *Crane* the Court held the devisee's basis of inherited property to be the fair market value of the property, not the equity, at the date of death of the decedent. No reference was made to the devisee's or decedent's "economic interest." If, then, the principle in *Crane* is to control, our query here is simply as to the fair market value of the building which passed to the heirs. Everybody agrees this was at least $450,000.00. (R. 26, 125.) This would seem to solve the problem of the heirs' basis for depreciation unless by their conduct (or the decedent's) they should be estopped to claim fair market value as a basis regardless of estate tax valuation. Estoppel is not advanced by the Respondent. The lower court says the basis is to be the fair market value but in the next breath it holds that the value as determined for federal estate tax purposes is conclusive and then only can the Petitioners be allowed depreciation if they show what value was given to the building for estate tax purposes. The court stated (R. 188-189):

> "It is true enough that the *estate tax valuation* * * * does operate to furnish a new base * * * for the depreciation of * * * property. In using the *estate tax-valuation* of property transmitted, however, the burden of showing whether any, and, if so, how much, of this interest, is upon the taxpayer, and, upon the undisputed facts as to the valuation for *estate tax* purposes here, that burden is a heavy one." (Emphasis added.)

By its constant reference to the estate tax value it is evident that the court thought there was some sort of option to be exercised by the taxpayer in establishing the appropriate basis and that in this case the Petitioners had elected to take the estate tax value method of determining their depreciable interest in the building. Absent this conclusion, it is difficult to perceive why the court recognized the fair market value rule but tied Petitioners to the estate tax valuation.

Petitioners also appreciate that *Brown Shoe Co. v. Commissioner, supra*, did not present a fact situation comparable to the one here. That case, however, did establish the principle, contrary to Respondent's argument there and here, that the taxpayer need not have an "investment," "economic interest" or "cost" in property in order to possess a depreciable interest.

Respondent brushes aside *Blanchard v. Commissioner, supra*, and *Rogers v. Helvering, supra*, as not being in conflict because they "involved nothing more than evaluations of stock." (Resp. Br. 9.) The fair market value rule for determining basis of inherited property is no different merely because personalty, rather than realty, is involved.

Respondent asserts no distinction. The controlling principle of basis law in those cases is too well established to allow the decision of the court below to go unchallenged. Petitioners rely upon those cases to show that the value used for federal estate tax purposes (although it is supposed to be the fair market value of the decedent's interest) is not conclusive on the heir in establishing his basis in inherited property under the income tax provisions of the Code. The court below held the value used for estate tax purposes to be conclusive and said that the agreed upon minimum fair market value of the building is "without material bearing" on the question posed! (R. 189.) It is fortunate that the courts have held the estate tax value not conclusive. If it were conclusive on both the government and the taxpayer, the heavy impact of a devisee's income taxes could often be lessened or averted by inflating the value of property on the decedent's estate tax return thereby establishing a high basis for depreciation deductions. This is not to mention the possibilities in such a situation of escaping income taxes by reducing gains or creating paper losses upon sale of inherited property due to "conclusive" inflated bases in disregard of the statutory standard, fair market value at time of death.

3.

Respondent urges denial of certiorari saying that to decide the case in favor of Petitioners would produce an incongruous result. Admittedly, it would be a result undersirable to the Respondent but certainly not necessarily an incongruous one. Even if it did amount to such, correction should lie in the field of legislation rather than in judicial

decision. It is not uncommon, in the field of taxation, for surprising results to occur both to the taxpayer and to the government. As was stated by the Court in *United States v. Cumberland Public Service Co., 338 U. S. 451:*

> "The oddities in tax consequences that emerge from the tax provisions here controlling appear to be inherent in the present tax pattern."

The Respondent tries to cloud the issue by suggesting duplication of deductions. (Resp. Br. 10.) He errs in this. Duplicate depreciation deductions would not result were Petitioners allowed the depreciation sought. And it is not the very same property. The lessee is not entitled to "depreciation" because he does not own the building. However, he has a "cost basis" in the improvement which he is allowed to amortize over the period of the lease or the useful life of the building. If his lease had been for 10 years he could have deducted 10 per centum annually to "recover" his cost. The lessee's deduction is "amortization" but "in the form of an allowance for depreciation." Actually his annual deductions are additional rentals, under Reg. 111, Sec. 29.23 (a)-10.

The Petitioners' deduction is actual "depreciation" because they own the building and its fair market value when inherited became their (substituted) basis in the property for determining gain or loss upon a subsequent sale as well as for depreciation. That is what Code Secs. 113 (a) (5) and 114 (a) very plainly say. Once it is determined that the taxpayer has a "basis" in wasting, depreciable property,

whatever it may be or from whatever source in fact or law it may have arisen, he is entitled to deductions for depreciation. This is the only manner in which he can save or recoup sufficient money with which to replace his "basis" at the end of the useful life of the property. It seems too evident to warrant mention that here the Petitioners inherited a building of considerable value and that at the end of the lease they will have a worn out building—a liability instead of an asset—on their hands. There is no way their "basis" in exhausting property can be preserved other than to set aside, by way of annual depreciation deductions, an amount of money which, at the end of its useful life, will be equal to at least its value when it was inherited. Often the lessor and lessee are entitled to depreciation and amortization with respect to the same property—the lessor on his "cost" or "other basis" and the lessee likewise. Here Petitioners claim a "basis" in the building by reason of the incidence of the federal estate tax and the Internal Revenue Code explicitly provides the measure of that basis. Once basis in a wasting asset is determined, depreciation deductions must automatically follow if it is to be recovered.

If the ancestor's basis in inherited property is as important as the Respondent would have the Court believe, it is surprising that the Code makes no mention of it.

Respondent does not deny the importance of the question in the administration of the federal tax laws. Indeed, it

would appear that cases of this nature involving large office buildings are widespread geographically and are just beginning to blossom into perplexing problems. *First National Bank of Kansas City v. Nee, supra*, involved property in Kansas City, Missouri; *Charles Bertram Currier, 7 T. C. 980* arose in Boston, Massachusetts; *Mary Young Moore, 15 T. C. 906* relates to Los Angeles, California, property and this case involves Dallas, Texas property. The opinion of the court below questions and inferentially criticizes the decisions of the Tax Court in *Currier* and *Moore* but expressly does not decide whether "the whole pyramid * * * must fall." (R. 190.) Until this question is settled by this Court many answers will be unknown.

Although the amount of money (tax) involved in this controversy is comparatively small, the depreciation deduction is an annually recurring matter. Over the remaining period of the lease (and in many other similar situations) the amount involved is substantial.

CONCLUSION

The decision below is incorrect. That of the Tax Court is correct on this record. There is sufficient conflict to warrant review. The question presented is widespread, important and troublesome in the administration of the tax laws. In any event, the court below should have remanded the case to the Tax Court to allow Petitioners an opportunity to supply the proof it considered essential to

sustain Petitioners' position, especially in view of the fact that the lower court disposed of the matter on an issue of nature or degree of proof not considered controlling by either party. The petition for writ of certiorari should be granted.

Respectfully submitted,

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STEPHEN L. MAYO,

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J. EDWIN FLEMING,
625 Republic Bank Building,
Dallas, Texas,
Counsel for Petitioners.

October, 1951.